RICHARD RUSSELL'S DOW THEORY LETTERS INCORPORATED

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Nov. 16, DJIA 1187.94; PTI 1607; A-D Ratio –20.32
Nov. 21, DJIA 1220.30; PTI 1621· A-D Ratio –20.08

THE PICTURE: There are periods in history, sometimes long periods, in which the market waffles and sputters, rallies and declines in such tedious and perfunctory fashion that we forget that underneath all these "meaningless" squiggles there beats a great tidal force – a tidal force waiting to express itself. That force, of course, is the great primary trend of the market. In all my reports of the past 26 years I have emphasized this tidal force or primary trend as it is known on Wall Street.

I have stated repeatedly that a knowledge of the DIRECTION of the market is the single most important fact that any investor can possess. To put it simply, the primary trend can make you or break you. When the primary trend is up, 85% of all stocks ultimately end higher. The converse is true when the primary trend is down.

How do we identify the primary trend of the market? We do it by examining the price structure of the Averages according to the rules put forth in Dow's Theory.

Is Dow's Theory infallible? The answer is no, or at least those who interpret the Theory are far from infallible. But I have been studying markets and systems for 40 years, and I have never found another system that is consistently better than Dow's Theory for classifying market trends, I have used aids, I have used augments to the Theory, but nothing, no single device that I have ever seen is better than the Theory itself.

The performance of the market over the last few weeks has been unimpressive. Considering the rising bonds and the decline in interest rates, one might even term the stock market's performance to be ominous. The daily high-lows have switched in favor of a plurality of new lows, the A-D line for the 30 Dow Industrials has broken down and perhaps worst of all – on days when the market does rally the action has been weak, breadth has been poor and volume has been uninspired.

Yet I want to give this market every benefit of the doubt. For that reason, I am listing below some of the danger points to watch, and I feel that the key low points in the D-J Averages should be monitored with particular care at this time.

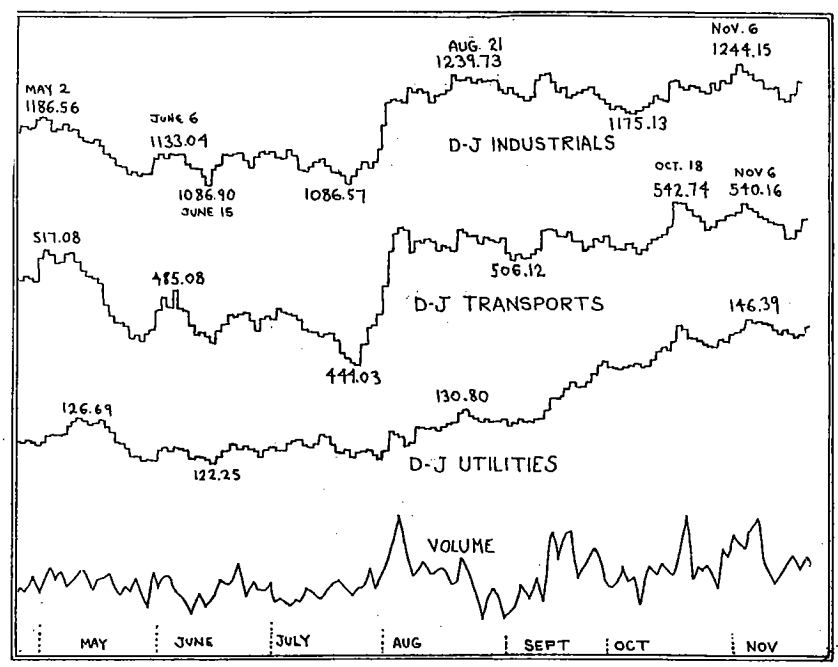
Let's review some of the technical indicators. First, on November 19 (see page 2 chart) my Primary Trend Index (PTI) broke below its 21-week moving average. This is obviously not a good omen. But the break was only fractional, and the PTI is still above its key trading range low of 1595, a low recorded on October 9. As this is written the PTI is holding just above the 1595 level, but I would have to say that any decline below 1595 would turn the PTI decisively bearish.

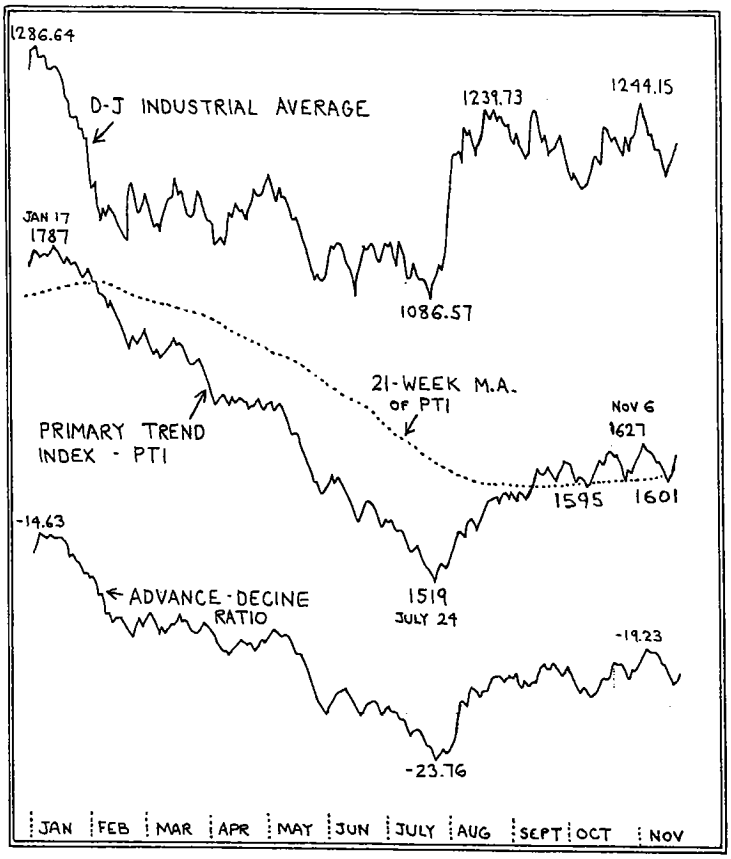
Next, as all subscribers must know, the D-J Averages (Industrials and Transports) have stalled in a narrow but extended range. The range has been bordered on the upside by the Industrial peak of 1244.15 and the Transport peak of 542.74. On the downside of the range we have the Industrial low of 1175.13 and the Transport low of 506.12. Such a concentrated and extended sideways structure (when it appears in BOTH AVERAGES) is termed "a line." Robert Rhea, the great Dow Theorist of the 1930's, believed that the breakout from a line (again by BOTH averages) could have primary significance. I tend to agree.

As this Letter is written, the Industrial and Transportation Averages are not too far from the lower limits of the line. If the two Averages were to break 1175.13 (Industrials) and 506.12 (Transports) respectively, I would take a very dim view of the situation. In fact, if the lows were broken decisively (particularly on expanding volume) I would opt for a reclassification of the primary trend from bull to bear.

All the fourth quarter stock market action has taken place within the context of a Reagan Presidential victory (supposedly bullish), a big rally in the bond market (supposedly bullish) and much conversation (and even political promises) regarding reducing the federal deficit. The stock market has been singularly unimpressed.

In recent Letters, I drew particular attention to the Value Line Composite, a very broad index comprising over 1600 stocks (see page 2 chart). I noted that the Value Line had formed what appeared to be a large head-and-shoulders bottom as seen on the point and figure chart. What has happened since then? The right

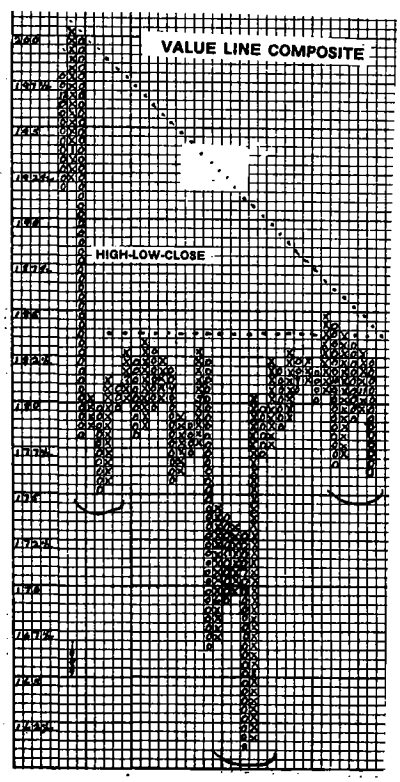




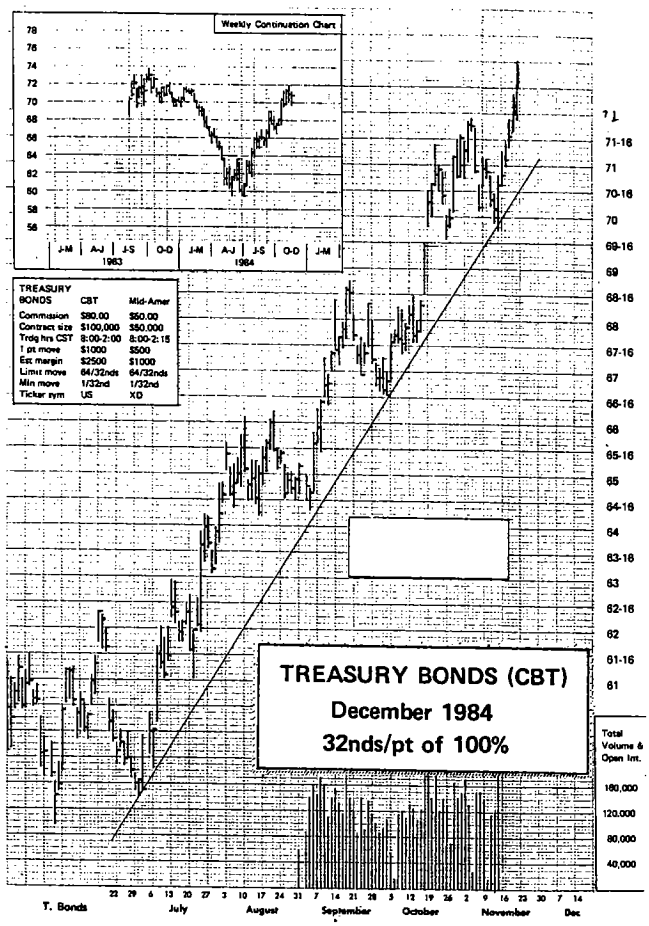
shoulder of the Value Line Composite has extended and now seems to have turned into a distribution pattern. On November 19 the V-L Composite closed at 176.37, a new low below the October low. This action tells us that the bulk of stocks are now sagging. And the V-L Composite has turned bearish.

At this point, I see the whole stock market and economy as part of a difficult balancing act. The declining interest rates are the positive and the obviously deteriorating trend of corporate profits is the negative. The Fed is taking a chance on reducing the discount rate in view of the precarious fundamental state of the dollar, for we must remember that foreign buying is a big factor in financing our deficits, and the last thing a foreign bond holder wants to see is a collapsing dollar.

The economists are dramatically split on what's coming up for the economy, and as a matter of fact, I don't remember seeing such a remarkable diversity of opinions on the part of the "big-name" economists. For that reason, I really thank the gods of Wall Street for providing me with such a faithful barometer of coming events. My feeling is that as long as the bottom of trading range holds for the D-J Averages, the bull case is the one we must adhere to. The trend (now bullish) remains in force until PROVED otherwise.



BONDS: In the 26 years which I have written these reports, I don't ever remember recommending bonds so strongly in Letter after Letter. At this point I feel it is obviously too late to take any sort of meaningful position in bonds. They have just gone too far on the upside. This daily chart (courtesy Dunn & Hargitt) shows the December Treasury futures, and this is the way we have followed the bonds ever since last June. The extraordinary rising trendline continues to be respected, and the trendline would be intersected by the bonds at 70½. A double bottom appears at 69¾, and I would recommend selling all trading positions if the 69¾ level is broken on the December contract.



Fundamentally, I think the argument for bonds grows weaker now, and I say this in view of (1) the disastrous trade deficit, (2) the horrible budget deficits, (3) the emerging US indebtedness to the rest of the world (i.e., the US as a banana republic), and (4) the potential world debt crisis and the vulnerablility of US banks.

But we'll ignore all this and stay with that trendline on the December futures. That line will ultimately be the thing that will part us from our bonds.

INVESTMENT POSITION: I have given the downside points or danger levels for the Averages. *As long as the market holds above these points*, the bull deserves his place in this box. On the day before Thanksgiving two items were added, either of which would ordinarily bolster the stock market. The first was the reduction of the discount rate to 8.5%. The second was the announcement of a record NYSE short position.

The investment I have greatly preferred is longer-term bonds, and I have urged this position in Letter after Letter. The bonds, to put it mildly, have been the most profitable investment over the past five months. How much longer bonds will continue their spectacular climb is problematical, but we don't have to guess here (see later section).

In the meantime, we'll give the stock market bull every chance to prove himself. As for gold, I don't see anything in the precious metals picture yet (despite the usual plethora of ads telling us that the precious metals are the way to riches).

TAXES, STALEMATES: In the last Letter I stated that President Reagan in no way enjoys a mandate and that furthermore the Republican position in Congress is now worse than it was during the first two years of Reagan's office. But the picture grows more ominous. The Administration is now talking about a budget deficit of as much as $210 billion in the current fiscal year. And this is based on a still expanding economy. But supposing recession hits? In that case, a budget deficit of above $250 billion would not be out of the question.

Various flat taxes are now being proposed, the foremost being the so-called "fair tax" and the "fast tax."' But the US Treasury considers taxes to be its domain, and it will shortly come up with its own tax plan. None of these new systems are supposed to bring in more revenue, they are calculated to be easier and to cut out many complicated deductions.

The Democrats are now in disarray, and they are already turning their attention to 1986. Their best ally will be chaos in the nation and a collapse in the Republican credibility. Therefore, Reagan can expect little or no cooperation from the Democrats, who control the House.

Reagan has stated that there will be NO tax increase, this in the face of the horrendous prospective budget deficits. The Democrats will absolutely hold Reagan to this, and therefore a 1985 tax increase is OUT of the question. The only other method of lowering deficits is to cut expenses, and this too will be fought at every turn by the Democrats and by many Republicans.

Seeing all this Irving Kristol (WSJ, Nov. 15) wrote a searing piece on the whole political and tax situation. I include the last two paragraphs of the Kristol piece. Read them carefully – they are probably the story of the next few years:

> As for the Democrats, having been crucified on this very matter during the campaign, they are not about to permit this administration to raise taxes. They will, as the saying goes, hold the administration's feet to the fire on this issue. They will either vote against any increase or at best (by which one really means at worst) propose their own kind of tax increase, which the Reagan administration could not even begin to consider.
>
> So on this crucial issue of tax reform, Mr. Reagan's second term is beginning most inauspiciously. He is missing an opportunity while the Treasury bureaucracy moves glacierlike. A lack of imagination is evident, along with an absence of a bold resolution to rely on Mr. Reagan's true and only constituency—the American people. As bits and pieces of the Treasury's bill are leaked to the press, controversy and anxiety will gain momentum. By the time that bill is finally written and approved by the other branches of the executive, the very idea of tax reform will be dead. The president should act now—and decisively.

The nation is now looking at the beginning of a major battle concerning taxes and spending. The battle will encompass politics, the philosophy of democracy, party compromise and good old statistics. The question: Can the President, the Senate, the House, and the two party political system deal with the awful reality of the US budget? If they can't, then we're in for more trouble than this nation has seen since World War II.

As I've said before, we have PASSED the time when this country can solve the budget problems without feeling pain. The pain is coming – it's just a quesiton of where and when. The reality is that spending (and the interest on previous debts) has so surpassed income that the nation is slowly approaching financial crisis. To give one example, the interest on the federal debt is now rising at the rate of roughly $20 billion a year. In other words, it will take a $20 billion spending cut or tax increase just to allow the Treasury to stand still.

The crux of the problem can be seen if one question is asked. The question: "What happened to the great 1981 tax relief?" Answer: it disappeared in inflation, higher Social Security taxes and gasoline taxes.

Nation's Business listed some of the major tax programs of the last decade. Inflation-induced bracket creep increased our taxes $650 billion. Social Security tax increases added another $377 billion. Increases under the "1982 tax reform" cost us $311 billion. Higher gas taxes cost $21 billion. The total tax increase amounted to $1.47 trillion. The total tax cut given to us by the government was $12 billion. A pathetic story.

Question: Russell, you've outlined a lot of the federal budget problems in the last few Letters. What do you think is really going to happen in this area?

Answer: We're dealing with probabilities and choices. One thing is sure and that is that the problem (i.e., the debt) is increasing at the rate of $3 to 3.5 billion a week (that's right, a week). Thus the crisis IS coming. How do I think the government will handle it?

(1) When the crisis comes, the government could make massive spending cuts. The Grace Commission has outlined spending cuts in the tens of billions of dollars that could be made. So far, nobody has taken the Commission that seriously (although it is rumored that Reagan does). Writer Donald Lambro ("Fat City" by Lambro is a book I have recommended) states that $200 billion could be cut from the budget by eliminating useless agencies, cutting out automatic cost-of-living boosts, eliminating worthless grants and useless research.

Thus, I really believe that when the crisis hits (and only then) can we get serious government spending cuts. That's one possibility.

(2) A second possibility is a moratorium on debt and specifically federal debt. This would entail a collapse in US credit and it would mean that the government could not continue to borrow. For this reason I think No. 2 is less likely than No. 1.

(3) A third possibility would be a move to all-out inflation as the Fed buys outstanding and new debt by the carload. This is a possibility, but as I have explained before, such action would shatter the bond markets, producing new highs in interest rates and deflation/depression. Therefore, I believe that monetary inflation may be tried but it will not solve the problem (the markets would not stand for it).

There is a (4) fourth possibility, and that is a combination of 1 and 2. This would be deflation and then a moratorium or default on debt. I say this because if this nation does move into a true deflationary cycle, GNP would slide precipitously, profits would dive, and tax receipts to the Treasury would collapse. In that case, the deficit would climb into outer space, and the nation would face a financial catastrophe. At that point, default or reorganization or a moratorium on debt would be the only way out.

The question might be asked, "In view of these three possible choices, what can the investor do to protect himself?" My only answer is – diversify. And I've suggested this many times. You can own your own house, own your own business (if possible), own stocks and bonds, keep a large chunk of liquid money in T-bills or moneymarket funds, and own at least a token amount of gold. Many people own collectibles in lieu of gold, and certainly judging from the unbelievable prices achieved at the recent NYC auction, top-quality name art has been a fabulous repository for money.

I want to add this to the discussion: People forget that the purpose of investing is to retain or augment one's standard of living. Thus the return or ultimate return on one's investment is the bottom line. And that is why I emphasized the great return on bonds, particularly at the June and July lows when good bonds were yielding 12 to 14%.

It was Charles Dow who underscored values and the return on investment. Dow advised buying stocks when average yields were high and selling them when average yields were low (under 3.5%). Dow observations have withstood the test of time. In my own experience I would say that for every trader who has garnered riches, there have been ten investors who have done the same. All investors have a single talent in common – they recognize great values.

Question: What do you think has been bothering the market?

Answer: I think that the market has been weighing the possibility or probability of recession in 1985. I think the market (consciously or unconsciously) knows that a recession and an accompanying drop in federal tax receipts could precipitate a crisis of the first order. I think that may be one thought on the market's mind.

I think the second thought is that deflation is now a real possibility. If a recession hits, it's going to hit many corporations which are now operating on thin profit margins and margins which could disappear if volume falls off. With corporate debt now high, any decline in volume is calculated to hit profits hard, very hard. And we are far past the point where a squeeze in profits can be offset by simply raising prices (a process which foreign competition would love).

I think the market may be worried about the sheer size of the bad debt now held by the banks. A recession could turn this bad debt into worthless debt. In fact, in the already recession-hit farm sector, many banks are reeling from bad loans, falling farm land prices and impecunious farmers who have been hit by higher costs and depressed commodity prices. These are just a few of the things that I think the market is mulling over at this time.

Question: Russell, everybody is now talking about the deficit and debt problem. When everybody sees something, can't we infer that they are all going to be wrong (contrary opinion)?

Answer: When you're talking about compounding debt rates and mounting deficits, I think it's dangerous to use contrary opinion. After all, we're dealing here with mathematical series, not opinion. When everybody knows that the interest on the federal debt is going up $20 billion a year, can we really say that on a contrary opinion thesis that it's not going to continue? No, contrary opinion should be applied to mass sentiment, not mathematical series.

MONEY, MONEY: Because I've been writing these reports for over a quarter century I occasionally indulge myself. I spout some of my philosophy. And it is strange, the readers who seem to like my "side trips" best are the wives of subscribers and the guys who write other market letters. Why the latter? I guess in this business, we've all developed some kind of philosophy or rationale for what we're doing, and other writers like to compare their thoughts with mine.

The special September issue of *Forbes* has created its usual ton of publicity because it lists the 400 alleged richest people in America. *Forbes* knows what it's doing – money interests just about everybody, and the nation's richest people are all part of the financial news game.

There are three ways of obtaining money. (1) You can *earn* it. (2) You can receive it as a *gift*, either through an inheritance, via a government handout, or through some other means. (3) You can *steal* it.

If you steal it, the odds are that you're somewhat nuts and you will probably get caught (in due time) so I won't address this group. If you inherit it or get it from the government or a pension fund, you're in good shape, and I won't address this group.

If you earn it, you have to make a lot of decisions, and one of those decisions is "What are you doing, why are you doing it, and do you like doing it?" There are numerous reasons why people opt in a big way for money. Some like the prestige, some do it to assuage their egos, some do it to prove that they are "better" than others, some do it because they feel it's fun to make money, and some do it because it's all they know how to do.

I've worked for 43 years. I've loaded trucks, I've designed textiles, I've dropped bombs on Nazis (that was a type of work,

too), I spent a year in an advertising agency, I ran a coffee house (as a hobby), and I write about investing and the markets.

Why do I work? First, I think it's good for me, it's one of the things that gives my life purpose. Secondly, I like the FREEDOM that money brings. In fact, the freedom concept is the thing I like most about working and making money. I like to be able to go to a good restaurant when I want, I like to be able to live where I want, I like to be able to buy the car or motorcycle I want. And I particularly like being able to buy things for friends and relatives (I happen to support a lot of people). Finally, I love the markets, I love the challenge of trying to figure out what the markets are saying. And I like to help people understand the markets, their investments, and what they are trying to do when they buy or sell stock or bonds or a house or what have you. And I'll admit it, I am somewhat of an accumulator. I collect art, stamps, coins, model cars, Cacti, and I even try to collect money. The truth is that when you have a certain amount of money you get a feeling of freedom (at least I do). For instance, a million dollars in muni bonds throws off roughly $100,000 all tax free. That's financial freedom in my book.

I often find myself staring at the executive faces in *Forbes* or *Fortune*. And wonder about those people. Some of them look great, others look terrible. Some look fresh and happy, others look tired and just this side of the grim reaper. You can tell a lot about a man's life from his face. It is said that up to 25, your youth saves your face. After 30, what you are shows on your face.

Everything we do in life entails a sacrifice, whether it's buying a house, buying a stock or having a kid. I mean everything takes not only a financial toll but a psychic toll. In other words, there is no way of going through life without worries, stress, and pressure. But to some extent you can pick your own level of worry and pressure.

How do you choose? Easy, you gauge the pluses and minuses. For instance, do you want a guaranteed way of putting pressure on yourself? Be a professional gambler. Do you want an almost sure way of avoiding big pressure? Work for the US Post Office and go for the pension. You want a fairly non-pressure job in medicine – be a researcher. You want to make a lot of money and take a lot of pressure in medicine – be a neurosurgeon.

No two psyches are the same. A great psychiatrist, Carl Jung wrote, "Your only duty on this earth is to find yourself and live accordingly." Another great physician (Sigmund Freud) said, "Love and work, that's all there is." A third psychiatrist (Frederick Perls) wrote that all life's emotional questions boil down to three: "What do you want? What do you feel? What are you doing?" My own opinion is that anyone who can fully comprehend those three statements and answer them with honesty, anyone who can do that is on the road to fulfillment and happiness. It's all in those three statements.

Yet I firmly believe that money isn't the answer, it's simply a tool. You can do a lot with money. You can possess a lot of freedom with money. But money can become an obsession just as day-trading commodities or building a business empire can be an obsession. And in the end, what does it all add up to? If it doesn't add up to satisfaction, you've probably been wasting your time.

Ross Perot is listed in *Forbes* as one of the ten richest individuals in the nation. Recently, I cut out a piece in which Perot was quoted regarding his views on money. I thought it was worth repeating here:

> "The most overrated thing in the world," says Perot, "is money—and that comes from a fellow who's worked since he was 12. I've lived pretty much all across the economic spectrum, and I'm no more happy and no less happy than when my wife and I first drove into Dallas with everything we owned in the back of our car. It breaks my heart to see young people coming out of business school with money as their god. People who do that inevitably are unhappy. They wind up with severe family problems. They're chasing the wrong thing. Money is just the by-product of building a company that delivers a better service, serves its stockholders, and deals fairly with its employees."

You know, there's a question I've asked myself, and it goes like this: "What would I do if I could do anything, and I wanted to guarantee myself a place in history?" The answer is not to be a businessman or a political leader or a great athlete. The surest way to live in posterity is to be a great artist (painter). Who was ruler of Holland when Rembrandt was painting? Who was the richest man in Spain when Picasso won his first prize at the age of 14? Who was France's leader when Renoir reached his artistic peak? No one remembers, but we know the artists. So do you want your name to ring through the ages? Do you want to give people pleasure 50 years, 200 years from now? Forget money, be a great artist, be a great composer, write a great novel. Do something that elevates men's souls, not their bank accounts. And your name will live in the pages of history.

NOTES & QUOTES: Supply and demand still works. And international crackdowns on drugs have resulted in the USA, Colombia and other South American countries seizing 27 tons of cocaine. Result: price of a kilogram of cocaine has risen in the last few months from $15,000 to $30,000.

* *

From a friend just back from Russia: "When demand for an item picks up in Russia, the supply doesn't increase – the lines just get longer."

* *

San Diego: Despite the fact that the mayor is under indictment, San Diego re-elected Roger Hedgecock by an overwhelming majority. The mayor is now on trial for perjury and conspiracy. Out-of-towners ask me what San Diegans are thinking of, electing a mayor who is on trial. I answer, " I think the sun gets them. You know we get about 340 days a year of sun, and I think it tends to parboil a lot of brains."

* *

By now subscribers must know that I'm a "read-a-holic." Not the least of my reading mania has to do with magazines. I love them. One of my favorites is the chic "Interview" put out by Andy Warhol. The current issue has a fascinating interview with Joan Rivers. The current issue of Esquire has a number of interesting pieces. One about dinosaurs centers on Jack Horner's research in Montana. Horner thinks that the dinosaurs were a lot more advanced than we think, and he wonders not so much why they disappeared but why they ruled the Earth for 140 million years (remember, man has ruled the Earth for maybe

100,000 years, maybe less). Another article centers on Margaret Chesney's heart research. She finds that cholesterol, obesity and Type A personality aren't the big causes of heart attacks – no, the "angry personality" is the killer.

* *

Famous words: From Mary Kay, founder of the $323 million (sales) cosmetic company. When asked about her age, "Why don't you just say I'm over 60? I say that women – to the age of 14 – need good parents and good health; 14 to 40, you need good looks; 40 to 60, you need personality, and after 60, what you need is character."

* *

Let's face it, the news these days isn't particularly happy. But every once in a while I read something that makes me smile. Here are two "smile items" from last week's papers.

> SYRACUSE, Kan. (UPI)—A coin flip Friday broke a tie in the race for the office of Hamilton County sheriff. Daniel Levens became the new sheriff when the coin came up tails.
>
> Republican Levens, a farmer, tied incumbent Democrat Thomas Lambeth in the Nov. 6 election, 759 to 759. County commissioners decided Friday morning to use a coin flip to determine the winner.

> TITUSVILLE, Fla., Nov. 16 (AP) — A small plane apparently took off on its own from an airport here, leaving its pilot standing in astonishment on the runway, officials said.
>
> The single-engine Cessna, last seen Thursday headed toward the Atlantic Ocean, was found in an unpopulated area at 6:40 A.M. today, about eight hours after its surprise departure from the Titusville-Cocoa Airport.
>
> An air-traffic controller who declined to give his name said the plane had crashed near the airport.

TECHNICAL NOTE: The short term trading index (MKDS on the Bunker Ramo machines) measures the average volume in rising stocks compared with average volume in declining stocks. As the STTI gets down around 50, we know that average volume in rising stocks is high, and this is bullish. Conversely, as the STTI gets up around 1.50 or more, we know that average volume in declining stocks is expanding and that's bearish. Anything over 2.0 denotes heavy selling pressure.

The dividing line is 1.0. On nine consecutive days ending with November 20, the STTI was over 1.0, and this indicated a very oversold market, In fact, the only longer strings of over 1.0 occurred in 1974 and 1970 (both of these strings were over 13 days in length). The 1970 string was followed by a sharp rally and then lower prices, the 1974 string occurred within a few weeks of the bottom. But as a rule, any string in the SSTI of nine days or more above 1.0 has been followed by a sharp upside action. Last week's string was no exception.

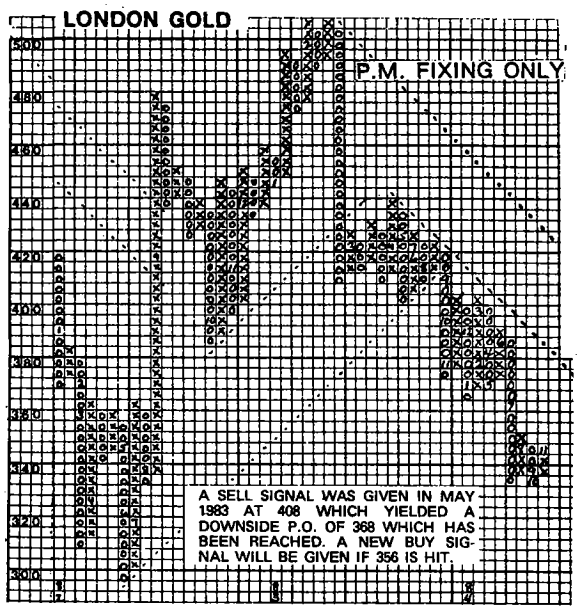
GOLD: Walt Bressert is one of the foremost experts on market cycles in the nation ("Market Cycles," 2020 E. Prince Rd., Tucson, AZ 85719). Walt starts his November 7 report as follows: "Most people are now familiar with the widely publicized 5½ year cycle in precious metals. Few realize that since 1933 almost all visible price lows actually occur 5-8 years from each previous low. With the most recent low (in gold) having occurred in 1982, the next low is due in 1987-90.

"In addition, since 1833, there is a cycle of silver of approximately 26-29 years that also applies to gold, as does the 5-8 year cycle. This cycle last bottomed in 1960 and topped in 1980. The combination of these two long-term cycles spells lower prices for both silver and gold."

In answer to the question of when the 5½ year cycle topped, Bressert opines that it topped in February 1983. Consequently, he does not believe that those highs will be bettered prior to a new major low which he expects to appear for the metals in the 1987-90 period. Bressert does not rule out final bear market lows for gold in the 100 area and final lows for silver at $2.

I've always found gold to be reliable, technically, particularly in regard to point & figure work. This chart (courtesy of Chartcraft, Larchmont, NY) shows gold fluctuating below two bearish trendlines. It would require a spot price of 380 to take gold to the lower of the two trendlines. A spot price of 356 would turn gold short-term bullish.

I want to state again that I place price movement far above my fundamental opinion or my personal scenarios for the future. I do not see inflation as a coming problem, BUT if gold hits 356 and then 380 I will revise my opinion of the metal accordingly. By the same token, I remain bullish on the stock and bond markets despite huge problems I see which should confront both before too long (in other words, price action is one thing, my opinion is quite another and market action always takes precedence).



LATE NOTES: Regardless of my own worries, the PTI and the Dow Theory have continued to keep me on the right side of the market. We had a spectacular upside day on November 23 (Friday), and that action served to push all my indicators away from "bear signal territory." The action came following a heavily oversold market, and I will want to see more before deciding whether this is just a bounce – or a really important turn to the upside.

NEXT MAILING: Dec. 12